OBAMACARE - INDIVIDUALS TAX EFFECT AND PLANNING ALTERNATIVES

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September 27, 2012

I. **FICA (FEDERAL INSURANCE CONTRIBUTIONS ACT) Medicare Tax Rate**

A. Effective January 1, 2013

B. Projected to raise, along with 3.8% increase, $20.5 billion in 2013 alone.

C. Increase in portion of FICA tax by .9% for employees with wages and self-employment income in excess of $200,000 or $250,000 for married couple filing a joint tax return.

1. Widowers are grouped with singles for Medicare tax.
2. For self employees individuals, the threshold amounts are reduced by wages taken into account in determining additional Medicare tax on wages.
3. If a self employed individual also holds a job, they may want to adjust their income tax withholding to cover the additional Medicare tax.

D. These thresholds are fixed by law and will not be adjusted annually for inflation.

E. Additional Medicare tax applied to earnings from wages and other taxable compensation such as tips, bonuses and non cash taxable fringe benefits.

F. This change increases employee's portion of FICA Medicare taxes from 1.45% to 2.35% for wages over threshold amount listed above.

G. The exercise of non qualified stock options and the vesting of restricted stock will trigger the .9% increase.

H. IRS issued guidance on the obligation of companies in July, 2012 to withhold the "Additional Medicare tax".

1. Regardless of employee's filing status, companies must withhold tax on compensation paid in excess of $200,000 during calendar year. Therefore, it does not matter whether the employee is married and combined joint income is under $250,000. The withholding applies in the pay period if which applicable threshold is exceeded on earnings.
2. If any employer fails to withhold the additional Medicare tax, the employee is responsible for paying the additional tax. However, the employer may be subject to penalties and additions to tax for a failure to withhold the tax under Code Section 3102(f)(3).
3. An employee cannot ask an employer to withhold additional Medicare taxes. They can, however, file a W-4, Employee's Withholding Allowance Certificate to request additional income tax withholding. The income tax can be applied towards the additional Medicare tax when employee completes annual tax return.
4. Any excess tax withhold is credited on tax return as additional income tax withheld.
5. Companies do not have to notify the employee when the collection starts for the additional Medicare tax. However, there is nothing to prevent them from doing so and it pay benefit employees to know about the new tax.
6. A Company does not need to withhold on an entire payment from, as an example, income from restricted stock vesting or stock option exercise that

pushes yearly income above $200,000 threshold. Additional withholding applies only to compensation above threshold.

7. For any compensation deferred under a 401(k) plan, additional Medicare tax is withheld when 1.45% part is withheld.
8. For any money received as an end of the year bonus that pushes an employee over the threshold, Medicare tax is not withheld until bonus is paid and only to extent that amount of bonus puts total compensation for year over threshold.
9. For a nonqualified deferred compensation plan, the additional Medicare tax applies the same as the basic Medicare tax. Therefore, deferred payments are subject to the tax in the year they are earned, unless there are restrictions on receipt of payment. If that is the case, then the tax would be postponed until restrictions are lifted.

II. **3.8% INCREASE**

A. Effective January 1, 2013.

B. Amount subject to tax is lesser of net investment income ("NII")or excess of taxpayer's modified adjusted gross income ("MAGI") over applicable threshold amount. MAGI is the amount reported on bottom of Page 1 of Form 1040 (AGI) plus any net amount excluded as foreign earned income.

C. The threshold amount is not indexed for inflation.

D. Single and head of household over $200,000 MAGI.

E. Joint filers and surviving spouse over $250,000 MAGI.

F. Married filing separately, over $125,000 MAGI.

G. Widowers are treated as joint filers for Medicare tax on unearned income.

H. For this, 3.8% tax, net investment income includes:

1. interest
2. dividends
3. capital gains
4. rents
5. royalties
6. some annuity income
7. income on the sale of principal home over $250,000 for individual and $500,000 joint (not full sale, just over threshold). Code Section 1211.
8. Net gain on sale of vacation home.
9. Passive investments where person does not materially participate.
10. Distributions from nonqualified plans.

NOTE: Investment Income is <u>reduced</u> by deductions that are "properly allocable" to the gain or less. For example, for passive real estate, depreciation and operating expenses are taken into consideration.

NOTE: There is ambiguity as to whether the earnings on a nonqualified compensation plan are subject to the 3.8% surtax. Any distributions, including amounts counted as interest, is generally treated as compensation, not as investment income, and not therefore subject to the

3.8% surtax. The non qualified deferred compensation is subject to Medicare at the time of vesting and any interest would be exempt from further Medicare tax.

I. Investments not taxed
   1. retirement account distributions from 401(k) plans; 403(b) plans; 457 plans and all qualified retirement plans.
   2. Social Security benefits
      a. The taxable portion of Social Security benefits provides a boost to MAGI even though benefits are not subject to the tax.
   3. Death benefits from life insurance proceeds
   4. Veterans benefits
   5. IRA and Roth Distributions
   6. Tax exempt interest
   7. Active trade or business income
      NOTE: Contrary to published articles, no active business income included. If taxpayer is not involved with passive activity business, NII includes only non-business income from rent, interest, capital gains, annuities, royalties and dividends. No business income included.
   8. Gain on sale of <u>active</u> interest in partnership or S-Corp
   9. Trusts for charity (except CLTs). Applies to charitable remainder trusts exempt from tax under IRC Section 664, trusts exempt from taxes under IRC section 501(c) and trusts where all interests are devoted to charity.
   10. Surtax to trusts and estates
      a. Annual surtax payable by trust or estate is 3.8% of lesser of undistributed net investment income or excess of AGI over the threshold amount ($11,200) for the highest tax bracket for trusts and estates begins.
      b. Will presumably not be applied to grantor trusts or simple trusts.

J. Retirees with sufficient net investment income with owe additional Medicare tax, even if they are receiving Medicare.

Example 1: For a Single Taxpayer's MAGI exceeding $200,000 threshold:

Claude, a single taxpayer, has net investment income from dividends and capital gains of $160,000 and MAGI of $240,000. Claude would pay a Medicare contribution tax on $40,000, which is the amount by which his MAGI exceeds his $200,000 threshold since it is less than his net investment income of $160,000. His additional 2013 Medicare contribution tax would be $40,000 x 3.8% or $1,520.

Example 2: For a Single Taxpayer's MAGI exceeding the threshold by more than the net investment income:

Judith, a single taxpayer, has a 2013 net investment income of $155,000 and a MAGI of $500,000. Since her MAGI exceeds the $200,000 amount by $300,000, more than the net investment income, she will pay the Medicare Contribution tax on her entire investment amount of $155,000. Her additional Medicare Contribution Tax for 2013 would be $155,000 x 3.8% or $5,890.

Example 3: Home sale for a married couple in excess of $500,000 exclusion:

Albert and Stephanie, a married couple, have 2013 AGI of $265,000. They just sold their principal residence for $1,300,000. They received a net gain of $750,000; therefore, the MAGI is $510,000 ($265,000 AGI + $250,000 sale of home in excess of $500,000 exclusion for a married couple). Since their MAGI exceeds $250,000, they have to pay the Medicare contribution tax on the gain of their house exceeding the $500,000 exclusion. Their Medicare contribution tax would be on the lesser of their home gain of $250,000 or $260,000 ($510,000 MAGI- the $250,000 threshold.) Therefore, their additional 2013 Medicare contribution tax would be $250,000 x 3.8% or $9,500.

Reducing the NII will reduce the amount of additional Medicare contribution tax payable dollar for dollar!

Example 4: Reduction of NII:

Betty, a single taxpayer, has $190,000 of salary and $65,000 of capital gains. Since she is over the MAGI of $200,000 for a single taxpayer, she should have to pay an additional Medicare contribution tax. She will pay the lesser of the NII ($65,000) or the amount over her $200,000 MAGI limit, or $55,000. She would be subject to the tax on the $55,000. Therefore, she would owe $55,000 x 3.8% or $2,090. However, if Betty had $25,000 in capital losses that year, she would reduce her NII to $40,000. Now, she would pay the lesser of $40,000 or $230,000-$200,000 or $30,000. Betty would now only have to pay a surtax on $30,000 x 3.8% or $1,140.

Example 5: Reduction of MAGI:

Abigail, a single taxpayer, has $150,000 in NII and a MAGI of $550,000. Since she has more than the $200,000 MAGI threshold for a single taxpayer, she is subject to the surtax. Abigail has a NII of $150,000 and an excess MAGI of $350,000. She would, therefore, be subject to the surtax on $150,000 since his NII is less than the excess MAGI. If Abigail can reduce her non-NII MAGI by $75,000, she would have a MAGI of $475,000, reducing her excess to $275,000. However, since her NII is still less than her excess MAGI, her surtax will be the same. However, if she can reduce her non-NII MAGI by more than $350,000, the amount subject to a surtax will be $0, even though she still has $150,000 of NII.

III. PLANNING ALTERNATIVES:

A. How about partially or fully converting your IRA to a Roth IRA? Micro-managing finances will be the new norm for 2013 and thereafter. Factors to consider:
   1. Having funds outside traditional IRA to pay tax on conversion.
   2. No lifetime required distributions from Roth IRA.
   3. Roth IRA allows infinite flexibility for lifetime distributions.
   4. Can reconvert back by Oct 15th of the following year. Only done in IRA, not qualified plan.
   5. Perfect post asset to utilize to micro-manage MAGI.

B. Minimum distributions from qualified retirement plans. For participant who have the ability to accelerate income in 2012 or for beneficiaries, take annual distributions up to $250,000 threshold and possibly don't utilize the maximum stretch payouts. An IRA is perfect vehicle to hold assets because it gives the taxpayer the flexibility to adjust income annually without constructive receipt.

C. Increasing contributions to qualified retirement plans.

D. Having employers increase tax free fringe benefits to employees instead of annual pay raises. The tax free benefits will allow employees to enjoy the benefits without additional income tax and without additional Medicare tax starting in 2013.

E. Encourage employees to take a end of the year bonus before December 31 rather than postponing receipt until next year.

F. Low or no interest loans from employer. The loans would generate interest income to employee and the low interest rates would not impose a significant tax cost. The loan would avoid all payroll taxes to employer and employee. The loan must be bona fide and have a promissory note and loan is carried on the books of company.

G. Possibly sell property in 2012 that you were going to sell anyway in 2013 if the sale is going to cause a payment of Medicare contribution tax.

H. Switching from corporate bonds (which interest is NII) to tax exempt bonds (in which the interest is not NII).

I. Purchase a deferred annuity.

J. Purchase a permanent life insurance coverage. Could then withdraw basis or borrow from policy when additional assets are needed.

K. Oil and gas investments. Intangible drilling costs associated with oil and gas investments can produce large current deduction, may be as much as 80% of amount invested.

L. If a trust or estate can choose between late 2012 or early 2013 as the end of the tax year, choosing 2012 will save on this surtax.

M. Establish a charitable remainder annuity or unitrust.

N. For sale of property, enter into Installment sales.
   1. Can spread out net investment income.
   2. Can help to avoid paying surtax in year of sale and subsequent years.

O. Maximize above the line deductions. Deductions made on Page 1 of Form 1040 reduce MAGI. Maximize your contributions to qualified plans, traditional IRAs and charitable contributions.

P. Determine whether to take capital gains before the end of the year. These gains will be subject to low capital gains rates and will avoid additional Medicare tax on net investment income that will apply to a sale next year.

Q. Possibly hold onto raw land that is expected to appreciate rather than income producing property so at least gain likely will be realized in a single year rather than annually.

R. Possibly electing not to treat capital gains and dividends as investment income for purposes of deducting investment interest. This will preserve or create net investment interest carryover that can be used after 2012 to reduce the investment income which is subject to 3.8% tax.

S. When donating to a charity, possibly donating appreciated securities rather than cash. This would avoid creating capital gains on sale of securities and enable a charitable deduction based on value of securities at time of gift. Cash that was not used for gift can be used to reacquire same securities, only now with higher basis. Fewer shares may be acquired with unused cash.

T. Where there is passive activity income, such as from a business in which taxpayer does not materially participate, engage in passive activity planning. A losses from an investment of passive activities may offset passive activity income.

U. Possibly income shifting strategies to family members with income below threshold. If investments are put into a family limited partnership (FLP) and giving interest to adult children with MAGI below threshold amount, they can save the additional Medicare tax. When giving property or interests to FLPs to younger children, it is not clear how kiddie tax and with additional Medicare tax intersect.

V. Maximize salary contributions to 401(k) plans and FSAs, contribute to health savings accounts.

Summary: Don’t try to avoid the new 3.8% and .09%. Be the sole judge on how to proceed. For example, converting an IRA to a Roth IRA accelerates the income tax on all amounts converted. Is that worth the “cost” to avoid the new additional Medicare tax? Every case is different so micro-managing ones overall assets on a yearly basis becomes more important than ever before.